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U.S. Sup. Ct.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1948

No. 83

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

vs.

MARGARET R. PHIPPS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 8, 1948

CERTIORARI GRANTED OCTOBER 11, 1948

TRANSCRIPT OF RECORD

United States Circuit Court of Appeals

TENTH CIRCUIT

No. 3542

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

MARGARET R. PHIPPS,
Respondent.

ON PETITION TO REVIEW THE DECISION OF
THE TAX COURT OF THE UNITED STATES

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THE TAX COURT OF THE UNITED STATES

Docket No. 8854.

MARGARET R. PHIPPS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Petition

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency (IT: Cl: P-7 BSK-90D) dated May 3, 1945, and as a basis of her proceedings alleges as follows:

(1) The petitioner is an individual residing at 3400 Belcaro Drive, Denver, Colorado.

(2) The notice of deficiency (a copy of which is attached hereto and marked Exhibit A) was mailed to the petitioner on May 3, 1945.

(3) The Commissioner determined a deficiency in income taxes for the calendar year 1937 in the amount of $2,268.37 and the amount of income tax in controversy is $2,410.85. The return involved was filed in the office of the Collector of Internal Revenue, Denver, Colorado.

(4) The determination of tax liability set forth in said notice of deficiency is based upon the following errors:

(a) Commissioner of Internal Revenue erred in finding that dividends received by petitioner on preferred stock of The Nevada California Electric Corporation in the

amount of $18,480.00 during the year 1937 was fully subject to income tax and failed to find that 51.3405% thereof or $9,487.72 was taxfree because that portion was distributed from Capital and not from earnings or profits.

(b) The Commissioner of Internal Revenue erred in failing to find that The Nevada California Electric Corporation had a deficit in its Earned Surplus Account as of December 31, 1936.

(c) The Commissioner of Internal Revenue erred in failing to find that The Nevada-California Electric Corporation had liquidated wholly owned subsidiaries on or about December 1, 1936, that four of such liquidated subsidiaries had accumulated deficits of $3,147,803.62 which the Commissioner should have debited to the Earned Surplus Account of the parent company, The Nevada-California Electric Corporation.

(d) The Commissioner of Internal Revenue erred in omitting or excluding as deductions from Surplus Account of The Nevada-California Electric Corporation the net losses recognized upon liquidation or the net deficits of certain subsidiaries liquidated prior to 1928 in the amount of $130,939.32.

(5) The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner filed her individual income tax return for the year 1937 with the Collector of Internal Revenue in Denver, Colorado.

(b) During the year 1937 petitioner received dividends on the 2,640 shares of the 7% preferred stock of The Nevada California Electric Corporation owned by her in the amount of $18,480.00.

(c) The Nevada-California Electric Corporation had a deficit in its Earned Surplus Account on December 31, 1936, in the amount of $79,964.80. That corporation had earnings and profits for the calendar year 1937 available for distribution (excluding said debit balance) in the amount of $390,387.02. Total dividends were paid by the corporation during the year 1937 on its 7% pre-

ferred stock in the amount of $802,284.00. Such dividends were taxable to the extent of such earnings for 1937 and said dividends were taxfree to the extent of $411,896.98 being 51.3405%, which portion was paid out of neither current earnings nor accumulated earnings and profits of prior years, but out of Capital.

4 (d) The deficit to the Surplus Account of The Nevada-California Electric Corporation as of December 31, 1936, in the amount of $79,964.80 is computed by taking into account the effect of certain liquidations of subsidiaries, as follows:

(1) On or about Dec. 1, 1936, The Nevada-California Electric Corporation, being the parent company, liquidated five wholly owned subsidiaires in taxfree liquidations under the provisions of Section 112 (b) (6) of the Internal Revenue Code. Four of these subsidiaries had substantial deficits in their Earned Surplus Accounts and one had a substantial surplus as of the date of such liquidation. As a result of these liquidations the parent company's Surplus Account was reduced by the net of such deficits in the amount of $2,119,974.88, computed as follows:

	Deficits	Surplus
Cain Irrigation Co.	1,740,592.54	
Hillside Water Co.	246,575.75	
The Southern Sierras Power Co.	1,094,697.86	
Yuma Utilities Co.	65,937.47	
The Nevada-California Power Co.		
Earnings prior to March 1, 1913		937,445.97
Earnings after March 1, 1913		90,362.77
Totals	$3,147,803.62	$1,027,828.74
	1,027,828.74	
Net Deficit debited to Surplus Account by parent company	$2,119,974.88	

(2) Prior to 1928 The Nevada-California Electric Corpn., being the parent company, liquidated seven subsidiaries in exchanges upon which gain or loss was recognized. As a result of these liquidations, the parent com-

pany's Surplus Account was reduced by either the
5 net of the losses sustained thereby or the net of the earned deficits of such subsidiaries, computed as follows:

Year		Losses or Deficits	Gains or Surpluses
1917	Central California Elec. Corp.	$ 43,885.56	
1918.	Hydro-Electric Co.	5,723.80	
1919	Rialto Light, Water & Power Co.		2,753.98
"	Bishop Light & Power Co.		2,171.82
1921	Pacific Power Corp.	85,886.91	
1927	Coachilla Valley Ice & Electric Co.	11,075.11	
"	Corona Gas & Electric Light Co.		10,706.26
	Totals	$146,571.38	$15,632.06
		15,632.06	
	Net Losses or Deficits debited to Surplus Account by parent company	$130,939.32	

Wherefore the petitioner prays that your court may hear the proceeding and determine that The Nevada-California Electric Corporation had a deficit in its Earned Surplus Account as of December 31, 1936, and that dividends received by the petitioner from such corporation in the year 1937 were taxable only to the extent paid out of current earnings for such year and that 51.3405% of such dividends, amounting to $9,487.72, were taxfree and that the Commissioner erred in including such amount in petitioner's taxable income for such year, and that there is no deficiency due from petitioner for the year 1937 but that petitioner overpaid income tax for the year 1937 in the amount of $142.48.

RALPH B. MAYO
Counsel for Petitioner.

[Verified.]

Exhibit A.

7 Return Filed in Colorado

Treasury Department
Internal Revenue Service
Denver 2, Colorado

May 3, 1945

Denver
IT:Cl:R-7
(BSK-90D)

Mrs. Margaret R. Phipps
3400 Belcaro Drive
Denver 9, Colorado

Dear Mrs. Phipps:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1937 discloses a deficiency of $2,268.37, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 918 Patterson Bldg., Denver 2, Colorado, for the attention of BSK-90D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accu-

mulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

Joseph D. Nunan, Jr.,
Commissioner,
By Bud E. Helvern
Internal Revenue Agent in Charge.

Enclosures:
Statement
870
Form of

Statement

Margaret R. Phipps
3400 Belcaro Drive
Denver 9, Colorado

Tax Liability for the Taxable Year Ended December 31, 1937

	Liability	Assessed	Deficiency
Income Tax	$8,922.82	$6,654.45	$2,268.37

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated July 6, 1939, and August 22, 1944; to your protests dated September 23, 1939 and September 12, 1944; to the statements made at the conference held on September 20, 1944 at the office of the Internal Revenue Agent in Charge, Denver, Colorado, and before the Western Division, Technical Staff, and to your claim for refund filed on March 10, 1941.

In your return you included in gross income the sum of $18,480.00, representing dividends received in the taxable year on preferred stock of The Nevada-California Electric Corporation. In your claim for refund it is claimed that said dividends are non-taxable under provi-

sions of Section 115(a) of the Revenue Act of 1936 as amended. In your protest of September 12, 1944, it is claimed that said dividends do not constitute taxable income to the extent of $9,487.72. It is held that said dividends constitute taxable income in their entirety. If a petition to the Tax Court of the United States is filed against the deficiency herein, the issue set forth in the claim for refund, and in the protest, should be made a part of the petition to be considered by the Tax Court in any redetermination of the tax liability. If a petition is not filed, the claim for refund will be disallowed and official notice will be issued by registered mail in accordance with Section 3772 of the Internal Revenue Code.

In your return you claim a credit for income tax paid at source in the amount of $371.38. It is held that such credit amounts to $465.48 and, accordingly, an additional credit for income tax paid at source is allowed in the amount of $94.10.

A copy of this letter and statement has been mailed to your representative, Mr. Ralph B. Mayo, 1200 Security Building, Denver 2, Colorado, in accordance with the authority contained in the power of attorney executed by you.

Year 1937

9

Adjustments to Net Income

Net Income as disclosed by Return	$41,200.84
Unallowable deductions and additional Income:	
(a) Fiduciary Income not reported	9,284.40
Total	$50,485.24
Non-taxable Income and additional deductions:	
(b) Additional contributions allowed	1,392.66
Net Income Adjusted	$49,092.58

Explanation of Adjustments

(a) It is held that the net income of the Margaret Rog-

ers Phipps Trust No. 2477A in the amount of $9,284.40 is includible in your gross income. See Phipps v. Helvering, 124 Fed. (2) 288, affirming 42 BTA 329.

(b) A deduction is allowed for contributions to the extent of 15% of the above-mentioned fiduciary income included in your gross income for the taxable year.

Year 1937

10 Computation of Tax

Net Income Adjusted		$49,092.58
Less: Personal Exemption		None
Balance (Surtax Net Income)		49,092.58
Less: Interest on Government Obligations	460.00	
Earned Income Credit (10% of $3,000.00)	300.00	760.00
Net Income subject to Normal Tax		48,332.58
Normal Tax at 4% on $48,332.58		1,933.30
Surtax on $49,092.58		7,455.00
Total Tax		9,338.30
Less: Income Tax paid at the source		465.48
Corrected Income Tax Liability		8,922.82
Income Tax Assessed: Original, account No. 200242		6,654.45
Deficiency of Income Tax		$ 2,268.37

Filed July 30, 1945.

Answer.

11 Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel,

Bureau of Internal Revenue, and for answer to the petition filed in the above-entitled proceeding admits and denies as follows:

(1) and (2). Admits the allegations contained in paragraphs (1) and (2) of the petition.

(3). Admits that the Commissioner determined a deficiency in income taxes for the calendar year 1937 in the amount of $2,268.37 and that the return involved was filed in the office of the Collector of Internal Revenue, Denver, Colorado, but denies the remaining allegations contained in paragraph (3) of the petition.

(4) (a) to (d), inclusive. Denies that the Commissioner erred as alleged in subparagraphs (a) to (d), inclusive, of paragraph (4) of the petition.

(5) (a) and (b). Admits the allegations of facts contained in subparagraphs (a) and (b) of paragraph (5) of the petition.

(c). Denies the allegations of fact contained in subparagraph (c) of paragraph (5) of the petition except it is admitted that The Nevada California Electric Corporation had earnings and profits for the calendar year 1937 available for distribution in the amount of $390,387.02 and that total dividends were paid by the corporation during the year 1937 on its 7% preferred stock in the amount of $802,284.00.

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(d) (1) and (2). Denies the allegations of fact contained in subparagraphs (d) (1) and (2) of paragraph (5) of the petition.

Denies generally and specifically each and every allegation set forth in the petition not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved.

J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel: Orris Bennett, Division Counsel; Roy C. Hornberg, Special Attorney, Bureau of Internal Revenue.

Filed September 5, 1945.

Stipulation of Facts.

13 It is hereby stipulated and agreed by and between the parties hereto, by their respective counsel of record, that the facts in this proceeding are as follows:

1. At all times mentioned herein, petitioner was a resident of Denver, Colorado. On or about March 15, 1938, petitioner filed with the Collector of Internal Revenue for the District of Colorado at Denver, Colorado, an individual income tax return for the calendar year 1937 disclosing a net income of $41,200.82 and a total income tax due of $6,654.45, which amount was duly assessed and was paid in quarterly installments during the year 1938 to the said Collector at Denver, Colorado.

2. During the taxable year 1937, petitioner was the owner of 2,640 shares of the seven percent $100.00 par value preferred stock of The Nevada-California Electric Corporation. Petitioner's basis for income tax purposes of each of said shares of stock was greater than the cash distributions paid by said corporation during 1937 on such stock. During the calendar year 1937 petitioner received from said corporation cash distributions on said shares of stock in the sum of $18,480.00, being $7.00 per share, which petitioner reported in full as dividend income in her return for the taxable year 1937.

3. On or before March 11, 1941, petitioner filed a claim for refund in the amount of $3,882.74 for the year 1937 on the ground that the aforesaid sum of $18,480.00 did not constitute taxable dividends. Copy of said claim for refund is attached hereto, made a part hereof and marked Exhibit A.

4. On May 3, 1945, respondent issued a statutory no-

tice of deficiency to petitioner proposing a deficiency in income tax for the year 1937 in the amount of $2,268.37, such deficiency resulting from adjustments not here in controversy. In said notice of deficiency it was stated that the dividends referred to in said claim for refund constitute taxable income in their entirety. The taxability of said dividends constitutes the only issue in controversy in this proceeding. Petitioner concedes that said dividends constitute taxable income to the extent that they were paid out of current earnings or profits of The Nevada-California Electric Corporation for the taxable year 1937, but denies that the excess of said dividends not payable out of current earnings or profits for the taxable year 1937 constitutes taxable income.

5. The earnings or profits of The Nevada-California Electric Corporation for the year 1937 were in the amount of $390,387.02. The total amount of cash distributions to stockholders by such Corporation during 1937 was $802,284.00, being distributions only to the holders of said seven percent preferred stock. The portion of such cash distributions which was payable out of current earnings or profits for the taxable year 1937 was 48.6595% ($390,387.02 ÷ $802,284.00). The portion of such cash distributions which was not paid out of current earnings or profits for the taxable year 1937 was $411,896.98, or 51.3405%

6. Of the above-described cash distribution re-
15 ceived by petitioner in the amount of $18,480.00, 48.6595%, or $8,992.28, was distributed by the corporation out of current earnings or profits for the taxable year 1937. The remainder, that is, 51.3405% of such distribution, amounting to $9,487.72, was not paid by the corporation out of current earnings or profits for the taxable year 1937.

7. On and prior to December 1, 1936, The Nevada-California Electric Corporation owned all the issued and outstanding capital stock of The Nevada-California Power Co., Cain Irrigation Co., Hillside Water Co., The Southern Sierras Power Co., and the Yuma Utilities Co. On or about December 1, 1936, each of said subsidiary corporations was liquidated by distributing all its assets, sub-

ject to its liabilities, to its sole stockholder, The Nevada-California Electric Corporation, in complete cancellation and redemption of all of its outstanding capital stock, whereupon each of said subsidiary corporations ceased to transact business and was dissolved. No gain or loss was recognized for Federal income tax purposes under the provisions of section 112 (b) (6) of the Revenue Act of 1936 on the liquidation of said five subsidiary corporations, and The Nevada-California Electric Corporation reported no gain or loss in its income and excess-profits tax returns for each year arising from said liquidations.

8. On December 1, 1936, the accumulated earnings or profits, or the deficits in accumulated earnings or profits, as the case may be, of said five subsidiary companies referred to in paragraph 7, *supra*, were as follows:

16	Deficit in Accumulated Earnings or Profits	Accumulated Earnings or Profits
Cain Irrigation Co.	1,740,592.54	
Hillside Water Co.	246,575.75	
The Southern Sierras Power Co.	1,094,697.86	
Yuma Utilities Co.	65,937.47	
The Nevada-California Power Co.		
Earnings prior to March 1, 1913		937,465.97
Earnings after February 28, 1913		90,362.77

9. As of December 31, 1936 The Nevada-California Electric Corporation had earnings or profits accumulated since February 28, 1913 in the amount of $2,129,957.81 and earnings or profits accumulated prior to March 1, 1913 in the amount of $18,060.94. Said amounts of $2,129,957.81 and $18,060.94 do not include the deficits in accumulated earnings or profits, or the accumulated earnings or profits, as the case may be, of the five subsidiary corporations referred to in paragraph 8, *supra*.

10. The Nevada-California Electric Corporation and its subsidiary corporations filed consolidated returns for the years 1918 to 1933, inclusive. The deficits and surpluses

and the earnings or losses as the case may be, of the five subsidiary corporations referred to hereinabove were not reflected in the earned surplus account on the books of The Nevada-California Electric Corporation prior to the liquidation of said subsidiary corporations on December 1, 1936, nor in the computation of earned surplus set forth in paragraph 9, *supra*.

RALPH B. MAYO,
Counsel for Petitioner.
J. P. WENCHEL,
Chief Counsel, Bureau
of Internal Revenue.

[Exhibit A of the stipulation of facts, claim for
17 refund, not designated as a part of the printed record, "since paragraph 3 of the stipulation shows that the claim was filed and the grounds thereof, and the claim itself adds no facts."]

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19 Filed May 20, 1946.

Findings of Fact and Opinion.

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8 T. C. No. 21. Promulgated January 28, 1947.

Ralph B. Mayo, C.P.A., for the petitioner.

Loyal E. Keir, Esq., and Thomas A. Steele, Jr., Esq., for the respondent.

A parent corporation in a nontaxable reorganization liquidated five wholly-owned subsidiaries, one of which had earnings and profits accumulated since March 1, 1913, in a comparatively small amount. The other four had deficits in such earnings and profits in an aggregate

amount much greater than the earnings and profits of the parent accumulated since March 1, 1913. Held, that a later distribution by the parent to its stockholders, including the petitioner, was, above the amount distributed from current earnings, distributed from capital. Commissioner v. Sansome, 60 Fed. (2d) 931; and Harter v. Helvering, 79 Fed. (2d) 12, followed.

This case involves income tax for the calendar year 1937. Deficiency was determined in the amount of $2,268.37, all of which is contested. In addition, the petitioner asserts an overpayment of $142.48. The sole issue presented is whether the petitioner is taxable upon the entire amount, or only upon a part, of a distribution made to her as stockholder of a corporation. All facts were stipulated, and we adopt the stipulation by reference and find the facts therein set forth. They may be summarized, so far as material to examination of the issue, as follows:

Findings of Fact.

The petitioner at all times pertinent was a resident of Colorado, and filed her return for the taxable year with the collector at Denver, Colorado. The return showed a net income of $41,200.82 and income tax due of $6,654.45, which was paid in 1938.

During 1937 petitioner owned 2,640 shares of preferred stock of The Nevada-California Electric Corporation, and in that year she received and reported for income tax purposes $18,480 distributions thereon. Her basis in the stock was more than the amount received in 1937. On or before March 11, 1941, she filed a claim for refund for the year 1937 in the amount of $3,882.74 on the ground that the $18,480 did not constitute taxable dividends. The deficiency notice issued May 3, 1945, held that the dividends referred to in the claim for refund constituted taxable income in their entirety. The petitioner concedes that they were taxable so far as paid out of current earnings or profits of the corporation.

The earnings or profits of the corporation for 1937 were $390,387.02. The cash distributions to stockholders during 1937 were $802,284, being distributions only to holders of preferred stock. It is stipulated that the cash distributions payable out of current earnings or profits was 48.6595 per cent and the portion of cash dis-
22 tributions not paid out of current earnings or profits was 51.3405 per cent, or $411,896.98. Of the $18,480 received by the petitioner 48.6595 per cent, or $8,992.28 was distributed out of current earnings or profits for 1937, and the remainder, 51.3405 per cent, amounting to $9,487.72, was not paid by the corporation out of current earnings or profits for 1937.

On and prior to December 1, 1936, The Nevada-California Electric Corporation owned all of the issued and outstanding capital stock of five corporations which were about that date liquidated by the distribution of all assets subject to liabilities to the sole stockholder, The Nevada-California Electric Corporation, in complete cancellation and redemption of all its outstanding capital stock, whereupon each of the subsidiaries ceased to transact business and was dissolved. No gain or loss was recognized for Federal income tax purposes on the liquidation of the five subsidiary corporations, under section 112 (b) (6) of the Revenue Act of 1936, and The Nevada-California Electric Corporation reported no gain or loss from such liquidation.

One of the liquidated corporations had on December 1, 1936, earnings or profits accumulated prior to March 1, 1913, in the total amount of $937,465.97, and accumulated earnings after February 28, 1913, of $90,362.77. The other four corporations had no accumulated earnings or profits, but had deficits totaling $3,147,803.62.

As of December 31, 1936, The Nevada-California Electric Corporation had (without including the deficits of the four liquidated corporations or the earnings or profits of the one liquidated corporation) earnings or profits accumulated since February 28, 1913, in the amount
23 of $2,129,957.81, and had earnings or profits accu-

mulated prior to March 1, 1913, in the amount of $18,060.94. It and its subsidiary corporations filed consolidated returns for the years 1918 to 1933, inclusive. The earned surplus account on its books did not reflect the deficits, surpluses, earnings, or losses of the five liquidated subsidiary corporations.

Opinion.

DISNEY, Judge: The portion of the corporate distributions by The Nevada-California Electric Corporation in 1937, not paid from current earnings or profits, was $411,896.98. The sole question here is whether that amount was paid from earnings or profits accumulated since February 28, 1913. The respondent contends, in short, that it was so paid, because Nevada Electric had at the beginning of 1937 earnings and profits accumulated since February 28, 1913, in the amount of $2,129,957.81; while, equally simply, the petitioner argues that the $2,129,957.81 was more than offset by the fact that in the liquidation of its five subsidiaries about December 1, 1936, Nevada Electric had taken over the deficits totaling $3,147,803.62, and had taken over only $90,362.77 earnings accumulated after February 28, 1913, by the one subsidiary having any earnings, leaving Nevada Electric to absorb deficits far greater than its own post-February 28, 1913, earnings, and therefore with no accumulated earnings, on January 1, 1937, out of which to distributed the $411,896.98—so that it was distributed out of capital tax free.

The issue revolves around the construction to be placed upon Commissioner v. Sansome, 60 Fed. (2d) 931; cert. denied, 287 U.S. 667. The respondent contends that case to be authority for adding to the earnings and
24 profits of Nevada Electric the accumulated earnings and profits of the one liquidated subsidiary having such. To this the petitioner agrees, but adds that it is also authority for passing to the parent corporation the deficits of the other four liquidated subsidiaries. To this the respondent objects, contending that earnings or profits of a liquidated corporation, if available for divi-

dends "*remain* available for dividends in the hands of the emerging corporation in a tax-free reorganization regardless of the operating deficits of certain of the constituent companies." Careful examination of the Sansome case is required. In that case the court, after pointing out the non-recognition features of the statute involved, providing that such "corporate transactions should not break the continuity of the corporate life," goes on:

"* * * Hence we hold that a corporate reorganization which results in no "gain or loss" under § 202 (c) (2), does not toll the company's life as a continued venture under § 201, and that what were "earnings or profits" of the original, or subsidiary, company remain, for purposes of distribution, "earnings or profits" of the successor, or parent, in liquidation. * * *"

Earlier in the opinion we find the thought: "Thus, there was income to tax as much as though the company continued its life."

In United States v. Kauffmann, 62 Fed. (2d) 1045, the court construed the Sansome case as holding that a nontaxable reorganization "was not such a change in corporate identity as prevented the new company from being considered as a continuing venture under § 201 of the Revenue Act of 1921 and that whatever were earnings of the original corporation continued to be such in the hands of the new corporation."

Baker v. Commissioner, 80 Fed. (2d) 813, involved five subsidiary corporations taken over by another in a nontaxable reorganization, and referring to the new corporation and the amount later distributed, the court said: "It had not in fact earned all of this amount itself, but *the combined taxable earnings* of itself and of the five predecessor companies made up that amount." (Italics supplied.) Harter v. Helvering, 79 Fed. (2d) 12, was by the same court, and the same judges, as the earlier Sansome case, and presents the identical question here at hand. There was in that case a nontaxable reorganization wherein two former corporations were merged into "New Company," which later was consolidat-

ed with Boxboard Co., the latter liquidating New Company and taking over substantially all of its assets. The court held that no gain was recognized in the reorganization between the two former companies and New, and said:

> * * * A consequence of this is that for purposes of allocating dividends under § 201 (b) of the Act of 1926, against earnings before and after March 1, 1913, the surplus is regarded as unchanged. * * *

Citing the Sansome case, the court proceeds:

> * * * Thus the surplus of the New Company was the difference between the assets of both the old companies and the capital shares of both, $4,307,134.34 of which only $2,085,587.78 was earned after February 28, 1913. Again when in April, 1926, the New Company consolidated with the Boxboard Company the same result ensued; for purposes of allocation the capital was $516,945 and the surplus, $4,289,745.39 of which $2,068,198.83 had been earned after February 28, 1913. * * *

Later on, referring to a distribution by Boxboard Co., it is said:

> * * * What was left was capital or earlier earnings; when the Boxboard Company took it over, it *retained this character*, and no distribution of it could be a taxable dividend. * * * (Italics supplied.)

Thus it appears that the same court which de-
26 cided the Sansome case holds that after a nontaxable reorganization "the surplus of the New Company was the difference between the assets of both the old companies and the capital shares of both"—and that the same was true in the second reorganization, between the New Company and Boxboard. Here, then, the surplus of the Nevada-California Electric Corporation consisted of the difference between the total assets of all of the old constitutent corporations, and the capital shares of all. In other words, the deficits in earnings and profits of the four subsidiaries enter into the synthesis of the

emerging surplus of the parent corporation. But if so, the deficits more than offset the earnings of both the parent and the other subsidiary which had earnings instead of a deficit. That such was the clear intent of the court is brought out by examination of the figures set forth by the court—for, as in the instant case, one of the constituent companies, in the second reorganization, to wit, Boxboard, had a deficit of $17,388.95—and "this deficit the court deducts in computing the surplus of the company resulting from consolidation of Boxboard and New Company; for, as above seen, the court computes the surplus of New Company prior to consolidation with Boxboard, as $4,307,134.34, and the surplus of the consolidated company as $4,289,745.39—less than the combined surpluses by $17,388.95. Thus it is inescapable that in that case the deficit of one company was subtracted from the surplus of the other. The respondent, on brief, in answer to petitioner's contention to the above effect, as to the Harter case, merely states that he "does not recognize such case as constituting a correct interpretation of the applicable law." Yet, the Harter case is interpretion of the Sansome case by the same court and the same
27 judges thereof, by whom the Sansome case was rendered.

This Court, in Senior Investment Corporation, 2 T.C. though in consideration of a different statute and question than herein involved, appears to indicate agreement with the principle of carrying the deficit of a merging company into the emerging company. Therein two companies were involved, Senior Investment Corporation, and Senior Corporation, formed as a part of a plan of reorganization of Senior Investment. The latter had a deficit in accumulated earnings and profits. In the nontaxable reorganization approximately two-thirds of the deficit was assumed by Senior, and about one-third retained by Senior Investment, the petitioner. The question before us was whether the petitioner was a "deficit corporation" and entitled to a credit, within the language of section 26 (c) (3) of the Revenue Act of 1936, as added by section 501 (a) (2) of the Revenue Act of 1942. We said:

* * * It is the rule that, where the assets of one corporation pass to a successor corporation in a tax-free reorganization, the accumulated earnings and profits of the old corporation pass to the successor with the same status and are available for the payment of dividends by the latter, Commissioner v. Sansome, 60 Fed. (2d) 931; certiorari denied, 287 U.S. 667; United States v. Kauffmann, 62 Fed. (2d) 1045; Reed Drug Co. v. Commissioner, 130 Fed. (2d) 288; Helen v. Crocker, 29 B.T.A. 773; and that, where only part of the assets are so transferred, it is proper to make an allocation of the earnings and profits between the two corporations in proportion to the assets transferred and the assets retained. Barnes v. United States, 22 Fed. Supp. 282; Estate of Howard H. McClintic, 47 B.T.A. 188, 202.

The respondent questions the petitioner's claim that it is a deficit corporation; but he makes no contention that the principles of the foregoing cases do not apply to the inheritance or absorption of a deficit. He questions the deficit only in two respects. * * *

The respondent's objections were to the method of dividing the deficit, and to the fact that it was computed on book values; so that his contention was that no deficit remained to the petitioner sufficient to support the credit asked. We held that regardless of which contention as to method of computation was correct, the petitioner had retained a deficit more than its later earnings and profits, so was in the taxable year a deficit corporation and was entitled to the credit sought. Thus appears recognition of offset of earnings of a reorganized corporation, by deficit prior to reorganization, for if after the reorganization, and in the taxable years the petitioner there had earnings and profits it would not have qualified for credit under the statute—yet it would have had such earnings and profits had the pre-organization deficit not been applied against them.

In Stella K. Mandel, 5 T.C. 684, we followed Senior Investment Corporation, supra, noting the "substantial identity of the old company in the several corporations in-

volved" and the "continuity of proprietary interests so as to make the rationale of the above cases applicable"—referring to the Sansome case and others relied on by the respondent in contending that "accumulated earnings and profits of a transferor corporation follow its assets in proportion thereto into the hands of a transferee on a tax-free reorganization, so as to be availble for dividend distribution." The principle was approved, despite the fact that the petitioner there was able to identify certain assets as acquired prior to 1913.

29 The respondent relies in part on Cranson v. United States, 146 Fed. (2d) 871; certiorari. denied, 326 U.S. 717. In that case a parent corporation in 1936 liquidated three wholly-owned subsidiaries, taking over their assets subject to liabilities in cancellation of the stock. The subsidiaries had an aggregate operating deficit of about $1,200,000. In the same year the parent had earnings of $931,553.82. It made a cash distribution in that year of $1.00 a share. The petitioner, a distributee, urged under the Sansome case that such earnings should be reduced by the operating deficits taken over so that he received capital, and not income. The court states that the Sansome case did not deal with the liquidation of a subsidiary, but that Regulation 94, article 115-11 recognizes the rule as applicable thereto, but did not extend the rule to embrace operating deficits, and calls the question an open one. Pointing out that whether or not the parent company suffered losses in prior years, if there were corporate earnings or profits in that year, the Revenue Act of 1936 provides that distributions to the stockholders in that year are deemed to be from most recently accumulated earnings or profits for that year, also that $931,553.82 had been earned in 1936 and undistributed profits were on hand in the amount of $139,631.26, the court approved the action of the lower court in taxing the distribution as dividends. It had earlier noted that the deficits were not shown to have occurred in 1936, and that the burden of showing error was on the taxpayer. The respondent urges that since the distribution was $1.00 a share on 937,743 shares of stock, more than the year's

earnings, the case is opposed to application of the Sansome case to deficits. The petitioner points out
30 that the amount of the distribution is not shown; and this is true. We only know that the distribution was $1.00 a share, but do not know the number of shares. It appears that in a later case, in the District Court, there was stipulation that in 1938 the number of shares outstanding was 937,743, but this does not appear in the report of the earlier case. The case is Cranson v. United States,——Fed. Supp.—— (U.S.D.C., N.D. Calif., November 12, 1943). We would not be justified in assuming such fact. Moreover, the point in the above case in the Circuit Court was whether previous inherited deficits would cut down current earnings (as is evidenced by the court's statement that the parent could not have deducted a deficit of its own), while here the sole question is as to effect of deficits on accumulated earnings or profits—the parties agreeing that so far as payable from current earnings the distribution is taxable. We do not consider the opinion in the Circuit Court as deciding the question presented to us here. The District Court decision, above referred to, for a later year, does recite a conclusion that operating deficits of subsidiaries do not diminish earnings or profits of the parent corporation otherwise available for distribution, but the facts of the case are not shown, and we may therefore not soundly predicate conclusion thereon.

After reviewing with care the above authorities we have come to the conclusion that the Sansome and Harter cases are controlling here. The primary principle announced in the Sansome case, and since consistently followed, was that a nontaxable reorganization does not toll the life of the constituent corporations as a continued venture, and it was only the result of that conclu-
31 sion to add that earnings or profits of an original or subsidiary corporation remained earnings or profits of the successor, or parent, corporation. The venture continues regardless as to whether there had been surplus or deficit in the finances of the constituent corporation; therefore, in our view, the deficit is carried for-

ward into the finances of the resultant corporation, equally with a surplus of any other constituent, and in both cases alike there is effect on the ability to distribute earnings and profits. The petitioner's corporation is merely a prolongation, in reorganized form, of a "substantial identity" of financial situation and a "continuity of proprietary interests," to use the words of the Mandel case, supra. No convincing reason appears to differentiate between surplus and deficit in the theory of continued venture. We hold that the distributions made by the parent corporation to the petitioner in the taxable year were, above the portion stipulated to be paid from current earnings, paid from capital and were not taxable dividends.

Decision will be entered under Rule 50.

Decision.

32 Pursuant to the Court's Findings of Fact and Opinion, promulgated January 28, 1947, the respondent having on March 26, 1947, filed a computation of tax, and the petitioner having on April 7, 1947, filed an acquiescence in said computation, it is

Ordered and Decreed: That there is an overpayment in income tax for the calendar year 1937 of $142.49, which amount was paid within three years before the filing of the claim for refund.

Entered April 14, 1947.

R. L. DISNEY, Judge.

Petition for Review.

3 The Commissioner of Internal Revenue, holding office by virtue of the laws of the United States, hereby petitions the United States Circuit Court of Appeals for the Tenth Circuit to review the decision entered by the Tax Court of the United States on April 14, 1947, ordering and deciding that there is an overpayment in income tax for the calendar year 1937 of $142.49. This pe-

tition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the United States Internal Revenue Code.

Margaret R. Phipps, is an individual residing at Denver, Colorado, and filed her income tax return for the calendar year 1937 with the Collector of Internal Revenue for the District of Colorado located at Denver, Colorado, which collection district is within the jurisdiction of The United States Circuit Court of Appeals for the Tenth Circuit wherein this review is sought.

SEWALL KEY,
Acting Assistant Attorney General.
CHARLES OLIPHANT,
Acting Chief Counsel,
Bureau of Internal Revenue,
Counsel for Petitioner on Review.

Of Counsel: CLAUDE R. MARSHALL, Special Attorney, Bureau of Internal Revenue.

Filed July 8, 1947.

Statement of Points to be Relied Upon

37 Comes now the Commissioner of Internal Revenue, petitioner on review in the above-entitled cause, by and through his attorneys, Sewall Key, Acting Assistant Attorney General, and Charles Oliphant, Acting Chief Counsel, Bureau of Internal Revenue, and hereby states that he intends to rely upon the following points in this proceeding:

That the Tax Court of the United States erred:

1. In holding and deciding that where a parent corporation merges with its wholly owned subsidiary in a nontaxable reorganization, the "deficit" of the liquidated corporation: "is carried forward to the finances of the re-

sultant corporation, equally with the surplus of any other constituent and in both cases alike there is effect on the ability to distribute earnings and profits".

2. In failing to hold and decide that where a parent corporation merges with its wholly owned subsidiary in a nontaxable reorganization the operating deficit of the liquidated corporation is not carried forward and merged with the surplus of the resultant corporation, and accordingly does not diminish such surplus otherwise available for dividend distribution.

3. In holding and deciding in effect that when
38 the parent corporation merged with its wholly owned subsidiaries in the nontaxable liquidations and the aggregate net amount of the operating deficits of such subsidiaries were more than the amount of the earnings and profits accumulated by the parent since March 1, 1913, such deficits were carried forward to the resultant corporation and merged with its surplus and absorbed it, thereby eliminating it for otherwise available dividend distributions.

4. In failing to hold and decide that when the parent corporation merged with its wholly owned subsidiaries in the nontaxable liquidation their accumulated net operating deficits, which was in excess of the accumulated Post-1913 earnings and profits of the parent, were not carried forward to the resultant corporation and merged with its surplus and did not absorb and eliminate it for available dividend distributions.

5. In holding that the distribution made by the parent corporation to its stockholders in 1937, of which taxpayer was one, (above the portion paid from current earnings) was paid from "capital".

6. In failing to hold and decide that the distribution made by the parent corporation to its stockholders in 1937, of which taxpayer was one (above the portion paid from current earnings) was paid from available earnings and profits accumulated since March 1, 1913.

7. In holding and deciding that the distribution made

by the parent corporation to its stockholders in 1937, of which taxpayer was one, (above the portion paid from current earnings), were not taxable dividends.

8. In failing to hold and decide that the distribu-
39 tion made by the parent corporation to its stockholders in 1937, of which taxpayer was one, was a taxable dividend in its entirety.

9. In holding and deciding that the conclusions reached in the cases of Commissioner v. Sansome, 60 F. (2d) 931, and Harter v. Helvering, 79 F. (2d) 12, are controlling in the instant case.

10. In ordering and deciding that there is an overpayment in income tax for the year 1937 in the amount of $142,49.

11. In failing to order and decide that there is a deficiency in income tax for the year 1937 in the amount of $2,268.37.

12. In that its opinion and decision are not in accordance with law and the regulations and are contrary to the evidence of record.

SEWALL KEY,
Acting Assistant Attorney General.
CHARLES OLIPHANT,
Acting Chief Counsel,
Bureau of Internal Revenue.
Counsel for Petitioner on Review.

Filed July 21, 1947.

Docket Entries

1 1945

Jul. 30—Petition received and filed. Taxpayer notified. Fee paid.

Jul. 31—Copy of petition served on General Counsel.

Jul. 30—Request for hearing at Denver, Colo., filed by taxpayer. 8/2/45 Granted.

Sept. 5—Answer filed by General Counsel.

Sep. 7—Copy of answer served on taxpayer, Denver, Colorado.

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Mar. 26—Hearing set May 20, 1946, Denver, Colorado.

May 20—Hearing had before Judge Disney on merits. Stipulation as to facts filed at hearing. Petitioner's brief due 7/1/46. Respondent's brief due 7/20/46. Petitioner's reply brief due 8/5/46.

Jun. 3—Transcript of hearing 5/20/46 filed.

Jul. 1—Bhief filed by taxpayer. 7/2/46 Copy served.

Jul. 16—Motion for extension to 8/9/46 to file reply brief filed by General Counsel. 7/19/46 Granted.

Aug. 9—Reply brief filed by General Counsel.

Aug. 19—Motion for extension to Sept. 9, 1946 to file reply brief filed by taxpayer. 8/26/46 Granted.

Sep. 9—Reply brief filed by taxpayer. Copy served.

Sep. 30—Appearance of William L. Branch as counsel filed.

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Jan. 28—Findings of fact and opinion rendered, Judge Disney. Decision will be entered under Rule 50. Copy served.

Mar. 26—Computation for entry of decision filed by General Counsel.

Mar. 31—Notice of hearing 4/16/47 on respondent's motion under Rule 50.

Apr. 7—Consent to settlement filed by taxpayer.

Apr. 14—Decision entered, Judge Disney, Div. 4.

Jul. 8—Petition for review by U. S. Circuit Court of Appeals, Tenth Circuit filed by General Counsel.

Jul. 10—Notice of filing petition for review sent to Wm. L. Branch filed.

Jul. 16—Proofs of service of petition for review filed (2)

Jul. 21—Statement of points to be relied upon filed by General Counsel.

Jul. 21—Designation of portions of record proceedings and evidence to be contained in record of review filed by General Counsel.

Aug. 1—Proof of service of designation and statement of points filed.

Certificate

42 I, A. B. Cypert, acting clerk of the Tax Court of the United States, do hereby certify that the foregoing pages, 1 to 41, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Præcipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 5th day of August, 1947.

A. B. CYPERT,
Acting Clerk,
The Tax Court of the United States
EMT.

(SEAL)

Filed August 9, 1947. Robert B. Cartwright, Clerk.

And thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Tenth Circuit:

Record Entry: Cause Argued and Submitted.

Thirtieth Day, November Term, Tuesday, January 6th, A. D. 1948. Before Honorable Orie L. Phillips, Honorable Sam G. Bratton and Honorable Walter A. Huxman, Circuit Judges.

This cause came on to be heard and was argued by counsel, Harry Marselli, Esquire, appearing for petitioner, W. Clayton Carpenter, Esquire, appearing for respondent.

Thereupon this cause was submitted to the court.

OPINION

[March 10, 1948.]

Harry Marselli (Theron Lamar Caudle, Assistant Attorney General, Helen R. Carloss, Lee A. Jackson, and Helen Goodner, Special Assistant to the Attorney General, were with him on the brief) for Petitioner.

W. Clayton Carpenter (Mortgomery, Dorsey, Wm. L. Branch, and Hughes & Dorsey were with him on the brief, for Respondent.

Before PHILLIPS, BRATTON and HUXMAN, Circuit Judges.

BRATTON, Circuit Judge.

This proceeding is here on petition to review a decision of the Tax Court. Margaret R. Phipps, hereinafter referred to as the taxpayer, owned certain shares of preferred stock issued by Nevada-California Electric Corporation. On or about December 1, 1936, Nevada-California Electric Corporation, hereinafter referred to as the parent company, liquidated five wholly owned subsidiary corporations and took over their assets in complete cancellation and redemption of all of their outstanding capital stock. No gain or loss was recognized for income tax purposes on the liquidation. At the time of the liquidation, one of the subsidiaries had earnings or profits accumulated prior to March 1, 1913, in the total amount of $937,465.97, and earnings or profits accumulated after February 28, 1913, in the sum of $90,362.77. The other four subsidiaries were without accumulated earnings or profits and had deficits in the total amount of $3,147,803.62. As of December 31, 1936, the parent company had earnings or profits accumulated prior to March 1, 1913, in the amount of $18,060.94, and it had earnings or profits accumulated since February 28, 1913, in the amount of $2,139,957.81, all exclusive of the earnings or profits of the one subsidiary and of the deficits of the four. The earnings or profits of the parent company for the year 1937 amounted to $390,387.02, and the cash distributions to owners of preferred stock during the year totaled $802,284.00. Of the cash distributed $390,387.02 was paid out of current earnings or profits, and the remaining $411,896.98 was not paid out of such earnings or profits. The taxpayer received distributions during the year 1937 in the amount of $18,180.00, of which $8,992.28 was paid out of current earnings or profits, and the remaining $9,187.72 was not paid out of such earnings or profits. She seasonably reported the entire amount for income tax purposes but later filed a claim for refund on the ground that the entire amount received and reported did not constitute taxable dividends. The Commissioner of Internal

Revenue denied the claim. The Tax Court held that of the amount distributed to the taxpayer, only $8,992.28 constituted taxable dividends. The Commissioner sought review.

The question presented is whether in determining the amount of earnings or profits of the parent company available for distribution to stockholders after the liquidation of the subsidiaries, the surplus of one subsidiary should be included but the deficits of the other four excluded, or whether the earnings of the one and the deficits of the four should all be taken into account. Section 22(a) of the Revenue Act of 1936, 49 Stat. 1648, includes dividends in the definition of gross income. Section 115(a) defines a dividend for purposes of the income tax title as a distribution in money or in other property made by a corporation to its shareholders (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year, without regard to the amount of the earnings and profits at the time the distribution was made. And section 115(b) provides that for purposes of the Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. It is well settled that where one corporation acquires all of the assets of another corporation in a tax-free reorganization, the accumulated earnings or profits of the predecessor corporation are carried forward intact into the acquiring corporation as earnings or profits and are available for distribution as dividends to its stockholders, even though the acquiring corporation may have treated them as capital on its books. Commissioner v. Wheeler, 324 U. S. 542; Commissioner v. Munter, 331 U. S. 210; Commissioner v. Sansome, 60 F. (2d) 931, certiorari denied, 287 U. S. 667; United States v. Kauffmann, 62 F. (2d) 1045; Murchison's Estate v. Commissioner, 76 F. (2d) 641; Harter v. Helvering, 79 F. (2d) 12; Baker v. Commissioner, 80 F. (2d) 813; Corrigan v. Commissioner, 103 F. (2d) 1010, certiorari denied, 308 U. S. 576; Geerday Enterprises v. Commissioner, 126 F. (2d) 384; Reed Drug Co. v. Commissioner, 130 F. (2d) 288; Putnam v. United States, 149 F. (2d) 721; Crossett Western Co. v. Commissioner, 155 F. (2d) 433, certiorari denied, 329 U. S. 729.

But the Commissioner urges that the rule is limited to the treatment of accumulated earnings or profits of the company liquidated or absorbed, and that it does not include carrying forward the deficit in earnings or profits of the company liquidated or absorbed into the corresponding account of the emerged company in determining whether distributions subsequently made by the emerged company to its stockholders are made from earnings or profits or from capital. In a tax free reorganization of corporations where a parent liquidates a wholly-owned subsidiary, taking over its

assets subject to their liabilities in complete cancellation and redemption of its issued and outstanding capital stock, or where two corporations merge, the entire corporate life survives as a continued venture insofar as tax consequences are concerned. A transaction of that kind does not produce any change in respect of tax purposes, the successor being merely the continuation of the predecessor. The principle is not a narrow one, limited to accumulated earnings or profits of the liquidated or absorbed company. It includes a deficit in the earnings or profits account of such company. The earnings and profits accounts of the transferor company, whether consisting of credit balances or deficits, should be reflected in the corresponding accounts of the transferee company and should be taken into account in determining whether distributions subsequently made to stockholders of the emerged company were paid out of earnings or profits or out of capital. Harter v. Helvering, supra. The case of Cranson v. United States, 146 F. (2d) 871, certiorari denied, 326 U. S. 717, on which the Commissioner places strong reliance is not to the contrary. There the taxpayer contended that the earnings or profits of the parent company were reduced by operating deficits taken over in the liquidation of wholly owned subsidiaries, and that in consequence the distribution made to him as a stockholder in the parent company was out of capital, not earnings. But the court did not pass upon that question. Instead, it was held that in the absence of an affirmative showing that the deficits of the subsidiaries were incurred during the year in which the parent made the distribution to the taxpayer, the question was not before the court for consideration.

Conceding that prior to 1936, where a corporation had a deficit in its earned surplus account caused by operating losses, the deficit must have been restored by applying earnings subsequently received against the deficit before any of the subsequent earnings could be considered as accumulated earnings available for distribution as taxable dividend, the Commissioner urges that the rule was modified by section 115(a) of the Revenue Act of 1936, supra; and that under the provisions of that section, current earnings are available first for payment of dividends, and only the current earnings which are not distributed may be used to restore a deficit in the earned surplus account. But the only change effected by the statute was to make dividends paid out of earnings or profits of the taxable year subject to tax in the hands of the distributee without regard to the amount of accumulated earnings or profits for earlier years, and that change has no material bearing here.

The decision of the Tax Court is AFFIRMED.

Number 3542.

JUDGE HUXMAN, United States Circuit Judge, DISSENTING:

I cannot escape the conclusion that the decision of the Tax Court is wrong and should be reversed. The factual situation is set out in detail in the majority opinion and will be referred to only so far as is necessary for the purpose of this opinion. The Nevada-California Electric Corporation will be referred to as the Parent. Prior to December 1, 1936, it owned five wholly owned subsidiary corporations. One of these subsidiaries had accumulated earnings after February 28, 1913, of $90,362.77. The other four had accumulated deficits of $3,147,893.62.

These five subsidiaries were liquidated on or before December 1, 1936, in a tax-free proceeding by a surrender of all of the assets to the Parent. No gain or loss was or could be recognized as a result by virtue of Section 112(b)(6) of the Revenue Act of 1936, and the Parent accordingly reported no gain or loss as a result thereof.

At the time these subsidiaries were taken over, the Parent had no deficit in its capital structure, but on the other hand had accumulated earnings and profits of $2,129,957.81 since February 28, 1913. The question for decision is whether, when these subsidiaries came over, their net deficit in their capital structure became the deficit of the Parent to be liquidated to the extent of the accumulated earnings and profits on the books of the Parent prior to 1937, so that when such earnings of the Parent were paid out to its stockholders they would constitute a return of capital rather than a distribution of earnings.

Both parties agree that the decision is controlled by the so-called "Sansome Rule" laid down by the Second Circuit in Commissioner v. Sansome, 60 F. (2d) 931. The parties to this litigation, as well as the court, are, however, unable to agree upon the interpretation of this case.

Ordinarily, when all the stock in a company is surrendered in return for all its assets, the assets are treated as capital without distinction between accumulated earnings and ordinary corporate assets. Income tax law, however, does not treat them thus. For income tax purposes, the accumulated earnings which come over retain such status by their recipients, and when the recipient is a corporation and subsequently distributes such assets, they constitute a distribution of earnings and profits taxable as a dividend to the stockholders of such corporation. This is the Sansome Rule and is all that the court decided in that case, as I interpret it. In order to reach this result, the court held that the life of the corporation taken over does not end as to its earnings and profits, but

continues in the successor corporation, so that such accumulated earnings remain available for dividends in the hands of the successor corporation.

But it does not follow that this oneness of identity continues for all purposes. The reason for the rule is to prevent, in a tax-free transfer of all of the assets of a subsidiary, a distribution of accumulated earnings, available for dividends subject to income tax in the subsidiary's hands, from becoming capital in the hands of the Parent and thus escaping taxation as income when distributed by the Parent.

When the reason for this rule ceases, it no longer has application and the separateness of corporate entity even between a Parent and its subsidiaries applies. To hold that the separateness of identity between a subsidiary and its Parent is to be disregarded for all purposes, in a reorganization in which the Parent surrenders all the stock in return for all of the assets, so that a deficit of the subsidiary could be set up on the books of the Parent as its deficit to be wiped out by the accumulated earnings of the Parent other than earnings of the current taxable year, would allow the Parent to distribute its accumulated earnings so set off against the deficits of the subsidiaries as a return of capital—the net result would be to allow the Parent to recognize loss in the tax-free transaction and would nullify Section 112(b) (6) of the 1936 Revenue Act. Such a theory would allow the Parent, by carrying the subsidiaries' deficits into its own books, to wipe out such deficits with its own accumulated earnings and profits and thereafter to distribute such earnings and profits as a return of capital free from the income tax, when otherwise a distribution of such earnings and profits would be a dividend subject to the income tax.

The Sansome case recognizes that this does not follow. In the Sansome case, the affiliate had accumulated earnings which would be taxable if distributed by it. These earnings passed to the Parent and were subsequently distributed by the Parent to its stockholders. When the Government attempted to tax this distribution in the hands of the stockholders, it was asserted that these earnings constituted capital; but as pointed out, the Second Circuit held that for the purpose of these earnings, the separateness of the two corporations would be disregarded and the earnings would continue as such in the hands of the receiving company. The court did not, however, hold or imply that the remaining capital assets of the affiliate became the capital assets of the Parent, or that the deficit, if any, in the capital structure of the affiliate came over and became a deficit in the capital structure of the Parent which could thereafter be liquidated out of accumulated earnings of the Parent.

Thus the Court, speaking of the taxpayer, said:

> "He could not successfully assert that such dividends must be computed as part of his gain on the transaction, but must be content with a corresponding allowance when he sold. * * * The taxpayer gets his quid pro quo in the closing transaction. Though it is a riance whether the final resultant will be favorable or not, the dice are not loaded against him."

Speaking of Section 112(b) (6), the court said:

> "That section provides for cases of corporate 'reorganization' which shall not result in any 'gain or loss' to the shareholder participating in them, and it defines them with some particularity. He must wait until he has disposed of the new shares, and use his original cost as the 'base' to subtract from what he gets upon the sale."

To permit the Parent to write off the deficit in the capital structure of its affiliates as shown by their books, after the reorganization by distributing its earned surplus income to its stockholders as a distribution of capital, permits it to recognize a loss of capital in the taking over of the subsidiary at the time of reorganization without the disposal of all of tht assets taken over, without the establishment of its cost base, and in direct contravention of the applicable statutory provisions. The Sansome case is no authority for this. In fact, as I construe it, it interdicts such a result.

The majority relies in part for its position that the deficit in the capital structure of the affiliates, after they are taken over by the Parent, may be liquidated by a distribution of the Parent's earned surplus as capital, upon the case of Harter v. Commissioner, also decided by the Second Circuit 79 F. (2d) 12. But to me, that case is not in point. In the Harter case, all the subsidiaries which came over to the Parent in the reorganization had large surpluses and no deficit in their capital structure. The Parent company did have a small deficit in its capital structure. In that case, two companies, each with earned surplus, merged to form a company referred to as the New Company. The New Company later became a subsidiary of the Boxboard Company. At that time, the New Company had a large surplus both from the operation of the Sansome Rule on the earned surpluses of its predecessors and from its own activities. The stockholders of the New Company received for their stock in such company both preferred and common stock from the Parent Boxboard Company. Boxboard did not, however, take over the assets of the New Company at that time. They were sold to a third corporation for cash and stock of such third corporation. Later Boxboard bought up and retired all its preferred

stock which it had given in exchange for the stock of the New Company. In order to pay for this stock, it borrowed $3,322,987.50 from its subsidiary, the New Company. Thereafter it took over all of the assets of the New Company and cancelled its note, given for the loan, held by the New Company against its notes payable account. The only question in the Harter case was whether the accumulated surplus of the New Company came over to the Boxboard Company under the Sansome Rule at the time of the loan transaction or at the time Boxboard took over all of the assets and whether the distribution thereof was of capital or of earned surplus. Thus, the court said:

> "The question is how to allocate the payment to the Boxboard preferred stockholders made out of the proceeds of the loan by the New Company."

The court then held that the loan transaction was not a true loan but that in reality Boxboard was distributing the accumulated earnings and profits of the New Company to retire its, Boxboard's, preferred stock. It inferred from the facts that Boxboard actually took over the New Company at the time of the so-called loan, so that the Sansome Rule operated at that time to bring over the accumulated earnings as such to Boxboard and were used by Boxboard to retire its preferred stock. This, it was held, more than exhausted such surplus, and since Boxboard itself had no surplus, the later distribution had to be from capital.

Nowhere in the reasoning of the court is a deficit in the capital structure of the Parent company alluded to, nor is any statement made as to what effect that would have upon the distribution to the stockholders by the Parent of earned surplus coming to it from the subsidiary in the reorganization proceedings. It was not necessary to refer to it because it was not a point in issue in that case.

Conceding, without so holding, that a parent may liquidate its own deficit by the distribution of taxable surplus coming over to it from an affiliate or a subsidiary by distributing such surplus to its stockholders as capital, it is quite a different thing to say that it may set up the bookkeeping deficit in the affiliate or subsidiary which comes over as its own deficit without a sale of all of the assets and a determination of the exact amount of its gain or loss, and then liquidate such bookkeeping deficit now set up on its books as its own by distributing its own surplus to its stockholders as a distribution of capital.

In Commissioner v. Munter, 331 U. S. 210, the Supreme Court placed its stamp of approval on the Sansome Rule as announced in the Sansome case. It may be of some interest to note that the Harter case was not even mentioned in the opinion. Apparently

neither of the parties to that litigation attached any importance to it. Had the Harter case been urged as a modification of the Sansome Rule or had the court been of the opinion that it had a bearing on the rule, it might have well discussed it in its opinion. It appears to me that the following language by the Supreme Court is the meat in the coconut. The court says:

> "The congressional purpose to tax all stockholders who receive distributions of corporate earnings and profits cannot be frustrated by any reorganization which leaves earnings and profits undistributed in whole or in part. Insofar as accumulated earnings and profits have been distributed contemporaneously with the reorganization so as to become taxable to the distributees, they, of course, cannot be said to have been acquired by the successor corporation. But insofar as payments to the predecessor corporations or their stockholders do not actually represent taxable distributions of earnings and profits, those earnings and profits must be deemed to have become available for taxable distribution by the successor corporation."

To permit a Parent company with large earned income surpluses on its books, which would be taxable if distributed by it to its stockholders, to take over affiliates with large bookkeeping deficits in a tax-free reorganization proceeding and then set up these deficits on its books as its own deficit and thereafter distribute its taxable earnings as capital to the extent of such bookkeeping deficit, in my opinion not only violates the express provisions of Section 112(b)(6), but violates the spirit of the Sansome Rule and the above quoted pronouncement by the Supreme Court.

For these reasons I am forced to respectfully dissent.

JUDGMENT

Sixty-third Day, November Term, Wednesday, March 10th, A. D. 1948. Before Honorable Orie L. Phillips, Honorable Sam G. Bratton and Honorable Walter A. Huxman, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

On April 15, 1948, the mandate of the United States Circuit Court of Appeals, in accordance with the opinion and judgment of said court, was issued to The Tax Court of the United States.

CLERK'S CERTIFICATE

United States Circuit Court of Appeals, Tenth Circuit.

I, Robert B. Cartwright, Clerk of the United States Circuit Court of Appeals for the Tenth Circuit, do hereby certify the foregoing as a full, true, and complete copy of the designated transcript of the record from The Tax Court of the United States, and full, true, and complete copies of certain pleadings, record entries and proceedings, including the opinion (except full captions, titles and endorsements omitted in pursuance of the rules of the Supreme Court of the United States) had and filed in the United States Circuit Court of Appeals for the Tenth Circuit in a certain cause in said United States Circuit Court of Appeals, No. 3542, wherein Commissioner of Internal Revenue was petitioner, and Margaret R. Phipps was respondent, as full, true, and complete as the originals of the same remain on file and of record in my office.

In Testimony Whereof, I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Tenth Circuit, at my office in Denver, Colorado, this 21st day of May, A. D. 1948.

ROBERT B. CARTWRIGHT,
Clerk of the United States Circuit Court of Appeals, Tenth Circuit.

By (S) George A. Pease
Chief Deputy Clerk.

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Supreme Court of the United States

Order allowing certiorari

Filed October 11, 1948

The petition herein for a writ of certiorari to the United States Court of Appeals for the Tenth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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